INTERGOVERNMENTAL FINANCE IN HUNGARY:

SUMMARY AND EVALUATION

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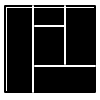

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The role that intergovernmental revenues play in local government finance differs widely across the world. Local governments raise much of their own revenues in Scandinavian countries such as Denmark and Sweden. A greater share is provided through transfers from the national government in countries such as Australia. Factors determining the relative size of the intergovernmental system include the extent of decentralization of expenditures and revenues, the capacity to raise revenues locally, fiscal and economic imbalances across the country, desires for equalization, the cultural heritage of the country, and others. Ultimately, the contribution of intergovernmental revenue is a country specific decision, with no share from transfers being appropriate across all countries. Nonetheless, the role that intergovernmental revenues play in local finance and the way that transfers are structured can affect economic efficiency, delivery of government services, equity, and other goals that a country sets for itself, meaning design of the system is very important regardless of the relative magnitude of the transfers.

This paper describes and examines the current intergovernmental transfer system in Hungary. The paper is composed of four sections. The first is an overview of the existing intergovernmental revenue system, including an analysis of each type of transfer. The next examines the transfer system in light of national goals. The third evaluates the structural characteristics of the transfer system. The final section presents some options for modifying the intergovernmental revenue system.

I. CURRENT HUNGARIAN INTERGOVERNMENTAL REVENUE STRUCTURE

Intergovernmental transfers made from the central government to counties and local governments are presented in Table 1 according to the standard budget structure used by the Government of Hungary. Transfers are categorized as shared revenues, accumulation revenues, state transfers and grants, and transfers within general government. Local government non-transfer revenues have been omitted from the Table. Transfers are budgeted to provide approximately HUF 825 billion in 1998, or about 72 percent of total local government non-debt revenues. Transfers have risen at a compound annual 14.2 percent growth rate since 1993, which is well below the 17.5 percent inflation rate during the same time period. Transfers have been falling as a share of GDP as well as in real terms. Still, the share of local government revenue provided through transfers has risen significantly since 1996, even though the percentage is lower than in the early 1990's.

Table 1
Total Intergovernmental Transfers, 1993-1998

	Budget of Local Governments (HUF Million)	1993	1994	1995	1996	1997	1998
	Revenues	**Actual**	**Actual**	**Actual**	**Preliminary Actual**	**Expected**	**Budgeted**
1	PIT	48,953	61,298	93,631	101,274	135,652	187,000
2	Vehicle tax	2,480	2,465	2,472	7,056	8,000	8,500
3	Tax on Land Rent						1,000
4	Shared revenues total	51,433	63,763	96,103	108,330	143,652	196,500
5	Accumulation revenues	6,514	15,370	7,392	11,820	10,000	9,000
6	Accumulation revenues total	6,514	15,370	7,392	11,820	10,000	9,000
7	Normative subsidies from central budget	214,790	221,674	232,650	231,702	255,893	276,133
8	Subsidies to theaters	2,286	2,375	2,574	3,462	4,338	4,770
9	Addressed and targeted subsidies	18,343	24,592	24,179	23,413	46,000	43,000
10	PIT supplement	6,480	6,480				
11	Deficit Grant (ONHIKI)	1,586	4,411	7,020	5,368	6,000	7,200
12	Other subsidies (Centralized Appropriations)	13,097	29,585	32,592	52,882	36,565	37,822
13	Subsidies for local fire protection			2,561	7,283	8,768	11,600
14	Supplementary Grants to Certain Public Education Tasks					3,247	6,507
15	Investment Grants with Regional Equalization Perspective				571	11,000	9,000
16	Decentralized Targeted Oriented Grant (Investment)						4,300
17	Public Employees Wage, Minimum Wage	5,337	9,150	6,285			
18	Other regrouped revenues	170	1,274	3,880	2,169		
19	State transfers and grants total	262,089	299,541	311,741	326,850	371,811	400,332
20	Funds from Social Security	91,625	117,447	127,055	148,417	169,000	190,900
21	Funds from EBFs	2,375	3,477	3,388	12,703	15,000	19,000
22	Funds from budgetary (chapters) institutions	4,757	6,624	6,044	7,213	8,000	8,000
23	Budgetary supplements and refunds	5,000	5,000	1,202	1,292	1,500	1,000
24	Transfers within general government total	103,757	132,548	137,689	169,625	193,500	218,900
25	Total Transfers	423,793	511,222	552,925	616,625	718,963	824,732

	Budget of Local Governments (HUF Million)	1993	1994	1995	1996	1997	1998
	Revenues	Actual	Actual	Actual	Preliminary Actual	Expected	Budgeted
26	GFS Revenues Total	578,311	705,778	790,109	940,437	1,021,263	1,142,532
27	GFS Expenditures Total			781,567	892,475	1,011,263	1,142,732
28	Transfers as a percent of revenues	73.28	72.43	69.98	65.57	70.40	72.18
29	State transfers, PIT, Revenues from land rent	311,042	360,839	405,372	428,124	507,463	588,332

Source: Compiled from Ministry of Finance documents.

For analytical purposes, the intergovernmental revenue structure can be usefully categorized as derivation based tax sharing and normative, earmarked, investment and deficit grants. This structure is used in this section to describe the system and to analyze how the individual intergovernmental components contribute to the overall system*s effectiveness. Intergovernmental revenues that are organized according to this scheme are given in Table 2.

Table 2

1998 Budgeted Intergovernmental Transfers (HUF Million)	
Shared Revenue	
PIT	93,500[1]
Vehicle tax	8,500
Tax on Land Rent	1,000
Shared Revenues Total	103,000
Normative Grants	
Normative Subsidies from Central Budget	369,633
Normatives Total	369,633
Earmarked Operating Grants	
Subsidies to theaters	4,770
Subsidies for local fire protection	11,600
Other subsidies (Centralized Appropriations)	37,822
Supplementary Grants to Central Public Education	6,507
Funds from Social Security	190,900
Funds from EBFs	19,000
Funds from budgetary (Chapters) Institutions	8,000
Budgetary Supplements and Refunds	1,000
Earmarked Operating Grants Totals	279,599
Investment Grants	
Addressed and targeted subsidies	43,000
Accumulation revenues within the state budget	9,000
Investment Grants with Regional Equalization	9,000
Decentralized Targeted Oriented Grant	4,300
Investment Grants Total	65,300
Deficit Grants	
Deficit Grant (ONHIKI)	7,200

Deficit Grants Total	7,200
Total Grants	824,732

[1]One half of PIT revenues in Table 1 is distributed as tax shares.
Source: Table 1.

Tax Sharing

Local governments receive percentages of the personal income (PIT), vehicle, and property transactions taxes, representing a budgeted HUF 103 billion in 1998 or about one-sixth of local revenues[1]. Tax sharing is a form of revenue sharing, where the amount to be transferred is determined by a percentage of collections of a national tax (or taxes) and the distribution is based on where the tax originates. Analysts of derivation-based tax sharing normally treat the revenues as intergovernmental transfers, though they have some characteristics of an intergovernmental transfer and some of a tax. The revenues are much like intergovernmental aid since the national government determines the revenues by setting the tax rate (or sharing rate) and the tax base and by collecting the revenues. Indeed, the taxpayer, unless very well informed, will think all of the revenues are national. The structure has the characteristics of a local tax system in that the revenues are owned where they are collected.

Derivation-based tax sharing has several advantages, including:

— Administrative costs are low, since the revenues are collected at the same time as the national share of the tax revenues.

— Revenue sources like personal income are buoyant, while other tax sources that often are assigned to local governments are slow growing.

A number of significant disadvantages result from tax base sharing, including:

— Lack of accountability if taxpayers do not understand that the shared revenues are provided to sub-national governments.

— Problems with horizontal balance are a significant concern. Horizontal balance refers to the capacity of each city and municipality to finance its service delivery responsibilities. Revenues from shared taxes are concentrated in the highest income (or other tax base) areas, as less affluent places have lower capacity to meet their responsibilities. Local

Municipalities also receive 30 percent of environmental fines.

governments receive widely different per capita revenues as a result of the derivation-based PIT sharing. For example, in 1995 Budapest collected HUF 18,300 per capita from PIT shared revenues, but the average local government with a population below 1000 received less than HUF 4,300.[2] Of course, horizontal balance problems do not only arise from derivation-based sharing. Essentially all tax bases are heavily concentrated in the same places, so no local taxes are likely to achieve horizontal balance.

— Tax sharing system normally is structured so that local governments are unable to alter their revenues by changing tax rates.

— Tax sharing discourages effective planning and service delivery when the specific percentages of taxes to be shared are selected each year to balance local budgets. Russia has used this strategy to set tax sharing rates. The percentage that is shared has been varied annually in Hungary as well, though it may be stabilized for the next several years. Tax shares should be set and left in place for at least three years.

— Derivation based tax sharing requires that rules be developed on where revenues are derived. In Hungary, PIT revenues are shared where the income earner lives. Administrative problems with determining the specific local government that should receive the tax revenues always exist. Also, any set of rules will entail certain inequities.

Countries must decide on a balance between tax assignment, where different levels of government are given access to specific revenue sources, and tax sharing, where different levels of government receive shares of the same taxes. The disadvantages of poor accountability are sufficiently great that the percentage of revenues coming from shared taxes should not be overly large.

Sharing of the PIT provides about 90 percent of total derivation-based revenues, or HUF 93.5 billion in 1998.[3] These derivation-based PIT revenues represent one-half (20 percent) of the 40 percent of national PIT revenues that are earmarked for local governments.[4] In Table 1 the 1998 PIT revenues include

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The 1996 Budget and Hungarian Local Government Finance: Back to Office Report," William Fox, Rita Melhem, and Gabor Petri, The World Bank, September 26, 1995.

[3] More recent budget estimates indicate that about HUF 89 billion will be shared in 1998.

[4] PIT equalization is included in the totals for the normatives and not as tax sharing.

both the derivation-based revenues and the PIT revenues that are earmarked for other purposes.

The actual amount of PIT revenues shared with local governments is based on tax collections from two years earlier because of the time necessary to prepare data based on the point of derivation. The two year lag causes a significant real revenue loss for local governments, given an inflation rate of greater than 17 percent. Stated alternatively, local governments* share of PIT revenues would be much greater if the distribution was based on the current year*s collections. For example, local governments* total earmarked share of PIT receipts is expected to be about HUF 180 billion in 1998, but the share would be about HUF 250 billion if 40 percent of expected 1998 PIT collections was distributed.

Two other taxes are distributed on a derivation basis. Local governments receive fifty percent of the nationally established motor vehicle tax and all of any additional revenues if they choose to impose a motor vehicle tax surcharge. Also, county administrative offices collect a tax on land and property transactions. Thirty percent is remitted to the municipality of origin, 35 percent stays with the county office to finance administrative expenses, and the remaining 35 percent is placed in a pool and provided to counties on a per capita basis.

Any undesired horizontal balance implications of tax sharing can be offset in a number of ways. For example, other transfers can be targeted to those areas receiving less in derivation revenues, or the PIT sharing can be at least partially distributed using a formula. Both alternatives are used in Hungary. The PIT distribution is made more equal by guaranteeing local governments a minimum per capita amount. In 1998, villages are assured of at least HUF 8,000 per person and towns of at least HUF 9,800 per person. The minimum amount has been escalated rapidly in recent years and is expected to cost HUF 33.34 billion in 1998, up from HUF 9.9 billion in 1996. The minimum PIT distribution combined with the needs based normatives described below provide a significant equalization component to the overall transfer system.

Normative Grants

Local governments and counties receive grants based on the value of a series of normatives (see Table 3). Most of the revenue from normatives goes to towns and villages, but about HUF 9.5 billion goes to the counties. The normatives effectively create a complicated formula-based grant structure, linked mostly to expenditure needs. The total amount of normative-based revenue going to a local governments is calculated by adding the amount to be received from each of the approximately 50 normatives.[5] The revenue provided according to the normatives is generally not earmarked, and may be spent for any purpose that the recipient government deems appropriate, even though the normatives are often linked to specific mandatory services.

Five types of normatives are used. First, several normatives are a fixed amount for each type of local government, such as the HUF 2 million given to each village. Second, some normatives are a per capita amount that is multiplied by population to determine the amount of revenues the local government is to receive. In these cases, population can be regarded as a proxy for service needs. Third, in many situations the normative is linked to the number of recipients or beneficiaries of services, and the amount received is calculated by

[5] Analysts have given different totals for the number of normatives, depending on how normatives are counted when multiple normatives are applied to a single situation.

multiplying the number of beneficiaries times the per beneficiary amount. Essentially all of the beneficiary normatives are related to education or social welfare. These normatives give local governments an incentive to deliver some degree of service because the revenues are only received if there are beneficiaries. Fourth, one normative is based on the number of beds in homeless shelters. Capacity normatives of this type are seldom used in the local government sector in Hungary, which is good because capacity normatives create perverse incentives as they encourage local governments to expand the capacity without necessarily improving the service quality. Finally, local tourist tax revenues are matched with two centrally provided forints for each one raised locally.

The notion behind the normative structure is that revenues should be provided in accordance with the diverse expenditure needs of each local government. The different normatives are intended to measure a range of expenditure needs, but local governments are left with some degree of flexibility on spending decisions since the revenues are not earmarked. Of course, local governments* expenditure flexibility is often less than it appears, because delivery of many services is mandatory, and mandates and standards in other laws effectively prescribe certain expenditures.[6]

It is tempting to think of the beneficiary normatives as cost reimbursement grants. However, in most cases the values attached to the normatives are not based on actual expenditures and bear inconsistent relationships with actual costs.[7] Even if an effort is made to relate the normatives to actual costs, there is no clearly defined statement of what specific service characteristics constitute provision of mandatory services, so it is not possible to associate the normatives with precise costs. Further, on average municipalities spend much more for the services than the grant that is linked to the beneficiary normatives, so at best the normatives are loosely defined, partial cost reimbursement grants.

Table 3

Normative and Normative Like Factors, 1996-1998

		1996	1997	1998
1	PIT equalization grant	9,940		

[6] Also, recipient governments can expect political pressure from advocates for each service to spend the revenues for the purposes on which the normatives are based.

[7] The Ministry of Social Welfare undertook a study of the costs of delivering social welfare services to use as a basis for setting normatives.

Normative and Normative Like Factors, 1996-1998

		1996	1997	1998
2	a) villages	up to 5,170 Ft/cap.	up to 7,037 Ft/cap.	up to 8,000 Ft/cap.
3	b) cities	up to 6,450 Ft/cap.	up to 8,643 Ft/cap.	up to 9,800 Ft/cap.
4	Transfer to county local governments for:			
5	a) Administration, sport, communal, road, bridge (based on permanent residents)	145 Ft/cap	312 Ft/cap	450 Ft/cap
6	b) For institutions operated by the county	-	956.3 mn Ft	10,800 Ft/benefic.
7	c) Lump-sum to counties	65.8 mn Ft	150 mn Ft	210 mn Ft
8	Grants to communal, administrative, cultural and sport functions of municipalities	1,761 Ft/cap	1,842 Ft/inhabitant	-
9	Municipalities in depressed areas	-	1,600/inhabitant	1,695 Ft/cap
10	County and Capital city administrative, regional, defense, cultural and pedagogical functions	512 Ft/inhab.	360 Ft/inh.	150 Ft/inhab.
	County/Capital city cultural activities	-	-	145/cap.
12	General grants for villages	2 mn Ft/village	2 mn Ft/village	2 mn Ft/village
13	District tasks of municipalities	-	-	4 mn Ft/selected municip.
14	a) for municipalities defined in Act 78/1997 para 52	-	-	200/capita
15	b) for municipalities defined in Act 78/1997 para 53	-	-	70/capita
16	Administration, sport, communal activities (based on permanent residents)	1,637 Ft/cap	312/cap	1200/cap
17	Matching grant to local tax on tourism	2Ft/tourism tax	2Ft/tourism tax	2Ft/tourism tax
18	Social welfare grants	2,800-7,000/inh.	3,500-10,500 Ft/inh.	2,500-12,500/inh.
19	Child and juvenile protection	270,000 Ft/beneficiary	330,200 Ft/beneficiary	400,000 Ft/beneficiary
20	Social and Child Welfare			
21	a) social and child welfare activities (social catering, home assistance, family assistance, etc.)	-	-	933/capita
22	b) for family assistance institutions	-	-	300/capita

	Normative and Normative Like Factors, 1996-1998			
		1996	**1997**	**1998**
23	c) municipal manager in municipalities with less than 2000 inhabitants	-	-	900,000 Ft (total)
24	Permanent and seasonal rehabilitation homes	202,000 Ft/benefic.	246,900 Ft/beneficiary	292,000/benefic.
25	Daily homes for elderly	36,200 Ft/benefic	48,000 Ft/benefic	60,000/benfic.
26	Seasonal homes for homeless	87,000 Ft/bed	102,200 Ft/bed	120,200/benefic
27	Homes for handicapped	289,500 Ft/benefic.	337,300 Ft/benefic	391,000/benefic
28	Child care institutions (Nursery)	-	(Govt. Decree)	161,000/child
29	Kindergarten	54,000 Ft/child	60,000 Ft/child	67,000/child
30	a) for part time kindergarten children	27,000 Ft/child	-	-
31	b) for municipalities with less than 3000 inhabitants	59,400 Ft/child	-	-
32	c) for non-resident children	59,400 Ft/child	-	-
33	d) for joint operation of kindergarten	62,100 Ft/child	-	-
34	e) ethnic kindergarten programs	62,100 Ft/child		
35	Primary education in classes 1-6.	56,700 Ft/pupil	64,000 Ft/pupil	72,000/child
36	Primary education in classes 7-8.	62,100 Ft/pupil	68,000 Ft/pupil	75,000/child
37	Education in classes 9-10.			
38	a) primary	64,800 Ft/pupil	70,000 Ft/pupil	76,000//pupil
39	b) secondary school (high school and special technical schools with high school exam)	66,200 Ft/pupil	70,000 Ft/pupil	76,000//pupil
40	c) vocational school	45,900 Ft/pupil	60,000 Ft/pupil	68,000/pupil
41	d) special vocational school	51,300 Ft/pupil	60,000 Ft/pupil	68,000 Ft/pupil
42	Education in classes 11-13.			
43	a) high school	75,600 ft/pupil	87,000 Ft/pupil	96,000/pupil
44	b) special technical schools with high school exam	79,980 Ft/pupil	87,000 Ft/pupil	96,000/pupil
45	c) vocational school	48,600 Ft/pupil	60,000 Ft/pupil	70,000/pupil

Normative and Normative Like Factors, 1996-1998

		1996	1997	1998
46	d) special vocational school	56,700 Ft/pupil	60,000 Ft/pupil	70,000/pupil
47	Training year after high school exam		-	-
48	a) in special technical schools with high school exam	86,000 Ft/pupil	-	-
49	b) in vocational schools	54,000 Ft/pupil	-	-
50	Additional Grants for training schools			
51	a) at classes 9-11 in special vocational schools	-	20,000 Ft/pupil	25,000/pupil
52	b) at classes 9-11 in vocational schools	-	40,000 Ft/pupil	45,000/pupil
53	c) class room training in vocational and special vocational schools	48,600 Ft/pupil	70,000 Ft/pupil	77,000/pupil
54	d) class room training in special technical school with high school exam	-	90,000 Ft/pupil	100,000/pupil
55	e) practical training in vocational schools	-	36,000 Ft/pupil	45,000/pupil
56	f) practical training in special vocational schools	16,200 Ft/pupil	28,000 Ft/pupil	30,000/pupil
57	Art training at basic level	35,100 Ft/pupil	40,000 Ft/pupil	45,000/pupil
58	Other public education grants			
59	a) for preparation of professional art examinations in special training schools	-	28,000/pupil	-
60	b) for preparation of professional art examinations in special vocational schools	-	36,000/pupil	-
61	c) for catching up programs in special training schools	-	10,000/pupil	-
62	d) for adjustment programs of pupils with behavioral problems	-	3,000/pupil	3,200/pupil
63	e) for teaching non-residential pupils			
64	1) in primary schools	5,400 Ft/non-res. pupil	9,000/non-res. pupil	10,500/non-res. pupil
65	2) in 9.-10. classes of high school and special technical schools with high school exam	8,600 Ft/non-res. pupil	-	-
66	3) in 11.-13. classes of high school	8,600 Ft/non-res. pupil	-	-
67	4) in 11.-13. classes of special technical schools with high school exam	10,320 Ft/non-res pupil	-	-

	Normative and Normative Like Factors, 1996-1998			
		1996	**1997**	**1998**
68	5) for training year after high school exam in special technical schools with high school exam	12,040 Ft/non-res. pupil	-	-
69	6) in special vocational school	5,400 ft/pupil	-	-
70	7) for practical training in special vocational schools	2,700 ft/pupil	-	-
71	8) in vocational school	5,400 Ft/pupil	-	-
72	9) for practical training in vocational schools	6,480 Ft/pupil	-	-
73	10) training year after high school exam in vocational schools	7,560 Ft/pupil	-	-
74	f) for joint educational service delivery			
75	1) in primary schools	8,100 Ft/pupil	10,800/pupil	12,000/pupil
76	2) in 9.-10. Classes of high school and special technical schools with high school exam	10,320 Ft/pupil	-	-
77	3) in 11.-13. Classes of high school	10,320 Ft/pupil	-	-
78	4) in 11.-13. classes of special technical schools with high school exam	12,040 Ft/pupil	-	-
79	5) for training year after high school exam in special technical schools with high school exam	13,760 Ft/pupil	-	-
80	6) in special vocational school	6,480 Ft/pupil	-	-
81	7) for practical training in special vocational schools	3,780 Ft/pupil	-	-
82	8) in vocational school	6,480 Ft/pupil		
83	9) for practical training in vocational schools	7,560 ft/pupil		
84	g) for municipalities with less than 3000 inhabitants		20,000/pupil	20,000/pupil
85	1) education in classes 1-6.	5,400 Ft/pupil	-	-
86	2) education in classes 7-8.	2,700 Ft/pupil	-	-
87	3) education in classes 9-10.	2,700 Ft/pupil	-	-
88	h) for municipalities with total number of inhabitants between 3000-3500		10,000/pupil	10,000/pupil

Normative and Normative Like Factors, 1996-1998

		1996	1997	1998
89	i) for catering in kindergartens and schools		8,800/pupil	13,700/pupil
90	j) for afternoon programs in schools		3,000/pupil	3,800/pupil
91	k) for operation of parental boards in kindergarten, school or dormitory	-	100/pupil	-
92	l) for operation of pupils' board	-	200/pupil	-
93	m) for sport association within the schools	-	1,000/pupil	-
94	n) for library	-	2,000/pupil	-
95	o) for bi-lingual schools	18,900 Ft/pupil	-	19,200/pupil
96	p) for ethnic minority primary school	18,900 Ft/pupil	-	-
97	q) for ethnic minority secondary school (high school and special technical school with high school exam)	25,800 Ft/pupil	-	-
98	r) for ethnic minority classes in vocational and special vocational schools	18,900 Ft/pupil		
99	s) for primary school evening and correspondence courses	21,600 Ft/pupil	-	-
100	t) for secondary school evening and correspondence courses	30,100 Ft/pupil	-	-
101	u) private pupils in primary, vocational and special vocational schools	16,200 Ft/pupil	-	-
102	v) bilingual schools (non-ethnic)	-	10,000 Ft/pupil	19,200 Ft/pupil
103	Dormitories	123,200 Ft/child	126,000 Ft/person	135,500/pupil
104	Special care with rehabilitation purposes			
105	a) handicapped children's care in special institutions	123,200 Ft/child	90,000/child	94,000/child
106	b) handicapped children's care at home	96,800 Ft/child	90,000/child	94,000/child
107	c) for handicapped children's care at home or in institutions if they do educational activity or participate in rehabilitation programs	96,800 Ft/child	103,000/child	130,000/child
108	d) for preparatory or developmental training of handicapped children	-	103,000/child	130,000/child
109	Cultural services	-	157 Ft/cap	555/cap
110	Earmarked Grants			

	Normative and Normative Like Factors, 1996-1998			
		1996	1997	1998
111	Grants for theaters (individual allocation)			
112	Fire Brigades	(discretionary)		
113	a) Non-stop service			
114	1) for fire brigade buildings		2,000.square meter	3,000.square meter
115	2) for vehicles		41 Ft/km	50 Ft/km
116	3) for special supporting equipment		250,000/piece	300,000/piece
117	4) for administrative costs		23,818/employed	27,033/employed
118	5) for special fire exhausting equipment		225,000/piece	250,000/piece
119	b) Temporary fire brigade services		1,247,912/employed	1,309,698/empl
120	1) personal expenses		997,912/employed	
121	2) operational expenses		250,000/employed	
122	Ethnic Programs	-		
123	a) Ethnic kindergartens	-	19,500/pupil	23,000/pupil
124	1) for minority language	-	-	24,500/pupil
125	b) Development programs for the gypsy	-	23,000/pupil	24,000/pupil
126	c) Ethnic schools	-	23,000/pupil	24,500/pupil
127	d) Supplementary grant for ethnic programs for small kindergartens and schools	-	18,000/pupil	20,000/pupil
128	e) Bilingual ethnic schools	-	23,000/pupil	27,000/pupil
129	f) Dormitory for gypsy children	-	-	10,000/pupil
130	e) Library for ethnic schools	-	2,000/pupil	2,200/pupil
131	ÖNHIKI= Deficit Grant			

Education Normatives

There are at least 26 education normatives, usually based on the number of students. For example, HUF 67,000 is provided for each kindergarten student and HUF 96,000 for each secondary student in grades 11 through 13. In some cases normatives are designed to provide incentives, as when a greater amount is given for non-resident students to encourage local governments to cooperate in service delivery. The Ministry of Culture and Education recognizes that the values are not based on an analysis of actual costs, but the normatives are set to cover education wages, or about two-thirds of total education costs. Cost estimates provided by local governments suggest that the normative values are sufficient to finance about 50 percent of kindergarten costs and about 80 percent of high school costs. There are also 7 pupil-based education grants for ethnic schools and programs. The ethnic normatives differ from others in that the moneys are earmarked for specific purposes.[8] Of course, the earmarked revenues are fungible and may have no effect at the margin on expenditure levels for ethnic programs, if the local governments were already going to spend more than the earmarked amounts for the services.

Social Welfare Normatives

Nine social welfare normatives are used. Beginning in 1998, the largest social welfare normative was split because of a concern that the range of social welfare programs was not being adequately provided. Basic social services for the general population are linked to three normatives, two of which are calculated using total population. Combined, these provide about 20 percent of the revenues from the social welfare normatives.

The other major normative is also provided on a per capita basis, with the amount transferred to local governments varying between HUF 2,500 and HUF 12,500 per person. The specific amount given depends on the extent of unemployment, percent of the population that is paying PIT, and percent of the population that is under 18 and over 60. The intent is to provide greater funding to municipalities that have larger social welfare responsibilities, though in a recent analysis of spending patterns the Ministry of Social Welfare found no relationship between program expenditures and factors in the formula. The specific definitions of the factors used to determine the normative*s value (for example, the meaning of unemployed) and the weights attached to the factors are set each year through discussions between the Government and the Parliament. Many issues may be considered in setting the amount for this normative, but one goal is to establish an allocation that achieves some pre-

[8] The normatives are generally described in Annex 3 of the budget, but each of the earmarked grants are contained in a separate annex. For example, the ethnic normatives are presented in Annex 8.

conceived (at least on a regional basis) conclusion about how the revenue should be distributed. The definitions and weights appear to be set to meet these goals.

Beneficiary-based normatives are also used for social welfare purposes. Five types of beneficiaries are identified including for homes for the elderly, homeless, handicapped, and orphaned, and for rehabilitation purposes.

Operation of the Normative System

Budgeting for normative grants begins with agreement between the government, Parliament, and local governments on the total amount of normative grants to be distributed. In the fall prior to the budget year, as part of the national budget planning process local governments provide estimates on the expected number of beneficiaries and the other factors that go into calculating the normative grants. The totals of these estimates are used to set average amounts (the normatives* values) that are the basis for the distribution across governments. Then, the normative values are used to calculate the amount that each local government is to receive. The local governments do not learn the amount they are to get until March of the year the money is to be provided. Payments based on these calculations are regarded as preliminary, and the actual normative payments are determined after the number of beneficiaries is determined at the year*s end. Local governments are paid additional amounts if they underestimated the number of beneficiaries and must repay excessive amounts if they over estimated beneficiaries. Interest is charged if the difference between the total estimated and total actual amount exceeds 5 percent. The State Audit Office inspects some municipalities to determine if the counts given by schools and other sources is accurate. A final reconciliation based on the audits can result in additional payments to local governments or a return of money if there were overpayments.[9]

The distribution of normative revenues to individual municipalities and the total amount provided are determined every year through the political process. The system is complicated and detailed, giving an appearance of preciseness, but the process is ad hoc and is routinely adjusted. The number of normatives used each year and the values applied to each have varied radically over the past several years (see Table 3). In part this reflects the newness of the government structure and attempts by the Government of Hungary to fine tune the transfer system, but it also may reflect manipulation to meet political

[9] The State Audit Office examines normative grants in about 500 municipalities per year, and performs comprehensive audits in about 40 to 50 other municipalities.

objectives. The use of more normatives is encouraged by advocates for specific programs who want to see funding linked to service characteristics. Annual changes in the major social welfare normative, where both the factors and their definitions are changed every year, provide an excellent illustration of how the structure is altered. The education normatives also have been subject to significant changes as the number of normatives and the value linked to each has been adjusted radically during each of the past three years. One outcome is that municipalities cannot accurately anticipate their revenues from one year to the next.

The normative system is complicated to operate. Population normatives can be easily calculated using estimates provided by the Central Statistics Office. However, the beneficiary normatives require careful compilation. For example, schools must follow detailed instructions on how to calculate the number of students. Many normatives, such as the number of students in classes 9 and 10, the number in classes 11 through 13, the number eating lunch at school and so forth, may apply to the same school, so many separate counts must be kept. One case was observed where 23 normatives applied to a single school. Generally these normatives are based on the average number of students each day, so daily counts (and sometimes more than once per day) must be maintained. Further, the academic year crosses two fiscal years so schools and local governments will normally need to follow two different sets of definitions and normative values during the same academic year.

The normative system should be restructured to reduce the complexities and to enhance revenue predictability. However, the normative system offers two advantages for the intergovernmental transfer system. First, it links transfers to expenditure needs, ensuring that revenues are positively correlated with needs. Second, it provides transfers to the local governments making the expenditures. The close linkage between transfers and expenditure responsibilities is important because many services are only provided by some municipalities. For example, only about 120 municipalities operate hospitals, and a minority of the municipalities operates secondary schools. Changes in the structure should be focused on reducing the problems, while retaining these strengths.

Earmarked Operating Grants

Funds from a number of grants are earmarked for operating purposes. These include annual grants for theaters and fire protection and the ethnic normatives mentioned above. In addition, a series of grants termed “centralized appropriations,” totaling HUF 37.8 billion in 1998, are given for earmarked

purposes. [10] The specific purposes often vary by year. In 1998 these grants are being made for children*s programs (HUF 9.5 billion), teachers* education (HUF 3.5 billion), textbooks (HUF 1.6 billion), severance pay for employees (HUF 1.5 billion), subsidies for public utility user fees (HUF 3.4 billion), public utility investment (HUF 2.5 billion), and old age protection (HUF 5.1 billion). Sectoral Ministries also have revenues to finance delivery of specific operational programs, and some of these funds are granted to municipalities. In the budget accounts these are termed funds from budgetary institutions. The total value of these programs is expected to be HUF 8 billion in 1998, the same as in 1997. The Ministry of Culture and Education, which provides grants for information technology, staff training, subsidies for school books, and other purposes, is responsible for much of these funds. The grants from centralized appropriations and funds from budgetary institutions are normally provided directly through sectoral Ministries, based on guidelines that were developed according to the legislation. The Ministries often have considerable flexibility for making the specific allocations of these grants.

Extra-budgetary funds provide operating revenues for earmarked purposes. The largest of these is the social security fund, which is used to finance health services including those provided through municipalities. Much of the revenue is distributed as reimbursement for the costs of service delivery. The labor fund, the second largest, assists municipalities in financing unemployment insurance benefits for people whose initial unemployment benefits have expired.

Investment Grants

Investment grants are made to finance specific projects that normally are selected through competitive bidding processes.[11] The funds are generally earmarked, since they are intended for specific projects. The projects often involve implementation across several years, so the grantors frequently make multi-year commitments. The funds remain unused in about 10 percent of the cases where investment grants are made. Among the reasons are local governments decide not to or are unable to provide their cost share.

Four categories of investment grants are made directly through the central government budget. Other grants may be made through the centralized appropriations described above. For example, in 1998 an appropriation was

[10] Accumulation revenues inside the state budget and funds from budgetary institutions are not categorized as centralized appropriations because they may also be provided to entities other than local governments.

[11] In most cases the transfer of these funds occurs as payment on the basis of invoices for actual expenditures, rather than through direct transfers to local governments.

budgeted to provide funding for sewer systems in Budapest and the 22 county rights cities.

Addressed and Targeted Grants

Addressed and targeted grants are the largest categories of investment grants. Projects financed through these grants are estimated to comprise 60 percent of all local investments.[12] Addressed grants generally provide 100 percent funding, and are made for large projects that have significant spillover benefits. The projects are selected by the Parliament, normally after recommendations from the Ministry of Interior and the sectoral Ministries.

Targeted grants are usually for smaller projects with lower spillovers, and are matching grants with an average of 50 to 60 percent national and 40 to 50 percent local financing. The grant component is increased 10 percent if the grantee is a municipal association. Between 1993 and 1995 the percentage paid by the national government varied by type of project, from 90 percent for clean water projects to 30 percent for projects
such as improving primary school classrooms.[13] The percentages paid by the national government were lower in 1996 than in 1993-1995.

Priority areas for targeted grants are set in the annual budget law. The major priorities for 1998 include: solid waste management, rehabilitation of dilapidated primary schools, medical equipment, and sewage and water systems that are linked together. Project applications are reviewed by the TAKISZ offices, the Ministry of Interior and the sectoral Ministries. All municipalities are entitled to apply for targeted grants and applications that meet all criteria are automatically approved, though funding may not be available.

Other Discretionary Grants

Sectoral Ministries and extra-budgetary funds make grants for investments in the same manner as they do for operational purposes. These revenues are termed accumulation revenues within the state budget in the financial accounts, and are expected to total HUF 9 billion in 1998, down from HUF 10 billion in 1997. The extra-budgetary funds and sectoral Ministries each have priority areas that were established by Parliament, but each has considerable flexibility in making the grants. Local governments and non-government entities can apply

[12] See, "Hungary: Regional Development Study," The World Bank, April 1998.

[13] "Subsidy System of Municipal Infrastructure Investments," The Urban Institute, March 1996.

for grants through these programs. Some programs require that a minimum percentage of the grants be made to local governments. For example, the Water Fund must provide 65 percent of its grants to local governments.

Three extra-budgetary funds make grants to local governments, the Environmental Protection, Road, and Water Management Funds.[14] Each operates under a long term plan that has been approved by Parliament. There is some overlap in their agendas, particularly between the Environmental Protection Fund and the Water Management Fund. Each fund has a separate decision mechanism for selecting the specific projects to finance. The Environmental Protection Fund makes grants or loans for purposes such as water and sewer (approximately 28 percent of the total), solid waste (about 25 percent), and air pollution. Financing for municipalities normally is in the form of grants, and is given with the expectation of 50 to 60 percent local cost sharing. The Water Management Fund provides grants for water and sewer projects, using financing from a portion of the water consumption fees. The Road Fund makes small grants to local governments for improving connector links to national roads. Grants provided by the Ministry of Social Welfare for hospital equipment are also categorized as accumulation revenues within the state budget.

[14] The extra-budgetary funds are financed through a variety of means. For example, the Road Fund is mostly financed with an excise tax on fuel, but the portion available for grants to municipalities (less than HUF 1 billion) comes from a 25 percent share of the central government*s part of the motor vehicle tax.

Regional Development Grants

Two grant programs are administered through the County Regional Development Councils that were recently formed in anticipation of EU accession. The regional councils are not local government bodies, though the councils include local government officials in addition to private sector representatives and others. These grant programs allow some investment funds to be allocated based on regional rather than national priorities. Grants from both programs must be made in accordance with the counties* development plans.

The first program, regional equalization grants, is targeted for distressed and less developed municipalities.[15] The subsidy is 10 percent greater if the grantee is a municipal association. The second program, regional development targeted appropriations, is available for all purposes and for both local governments and non-government entities. Either grants or recurrent subsidies can be given.[16] The grants are made with the requirement that at least 20 percent of the funding comes from the local governments, though there is no explicit mechanism for ensuring that local governments meet their commitments. The Regional Development Councils normally provide grants of under HUF 200 million, and these programs are seen as being given in place of smaller targeted grants. Larger grants still must be obtained through the addressed and targeted programs. This financing dichotomy may provide incentives to increase or decrease the size of projects, depending on which structure offers the best terms and easiest access to grants.

Coordination of Investment Grants

Investment grants are poorly coordinated because there is a huge volume of applications and a large number of granting agencies. Municipalities often bid for every possible grant, with the hope of being successful on an acceptable share.[17] As a result each municipality often applies for multiple grants for the same project and for grants for many different projects. There are many incentives for municipalities to bid for numerous grants. Uncertainty about the

[15] Formally, the regional development subsidies are made through the Ministry of Environment and Regional Development and the regional equalization grants are made through the Ministry of Interior. The Ministries use a scoring system (which is approved by Parliament) to determine the distribution of revenues across counties and then allow the Regional Development Councils to make the specific allocations.

[16] Some private sector grants include interest subsidies.

[17] One municipality indicated that it submits as many as 1000 applications annually, though only a small portion of these request significant resources.

overall grant system causes local governments to apply for funding now, since they worry that financing will not be available later. All of the schools or other institutions in the same municipality may apply for the same grant program. Municipalities are not prohibited from simultaneously applying for and receiving grants for the same project through many of the programs described above. For example, water and sewer projects can obtain funding through the addressed, targeted, environmental
protection, water fund and regional grant programs, and possibly through others.

The large number of applications means that most grant programs have applications for much more financing than is available.[18] Further, the volume of applications precludes comprehensive reviews of projects by the granting agencies. In fact, projects are seldom evaluated in terms of their economic viability. Factors such as whether the local government appears able to finance its share of the cost play a much greater role in the decision process than does project quality, even though the fungibility of resources means there is little information in a local government*s apparent financial capacity. All of these considerations increase the chance that decisions are based on grantsmanship and political criteria. Small communities are disadvantaged the most because they do have the resources to complete for as many projects.

Some organizations, such as the Environmental Protection Fund, make grants based on recommendations from inter-ministerial committees, which allows for some coordination between grantors. Unfortunately, these committees have failed to create a well coordinated system. Grantors often have different application processes, filing requirements, and selection criteria.

Poor coordination results in four problems. First, project selection is likely to be sub-optimal, both for allocations across sectors and for choices of specific projects. Second, some projects have received grants totaling more than 100 percent of their cost. The quality of projects proposed by local governments can be seriously diminished since there is little incentive to select optimal projects when the entire cost is borne externally. Third, conflicts between agencies can result in project work commencing, but the project never being completed as some sources of finance fail to materialize. The different granting sources may make financing available on inconsistent schedules, particularly for multi-year projects. Finally, significant administrative burdens are created for both local governments and the national government.

Resolution 263 of 1997 was adopted to allow more effective coordination

[18] For example, the Road Fund annually receives about 1000 applications, of which it can fund about 150.

of the resources managed by the Ministries and the extra-budgetary funds. The Resolution also allows the Treasury to monitor disbursements of grant funds from the different sources.[19] The system for implementing the Resolution has not been fully developed as yet, and the resolution is best characterized as laying out an objective. The expectation is for a single tender to be issued for all projects of the same type. Local governments will apply once to the institution where the largest grant is being requested. The evaluation process for all prospective grants for each project is to occur simultaneously, with the institution receiving the proposal being responsible for coordination with other potential grantors. Presumably this will allow better overall targeting of investment funds, and will reduce the possibility for excessive grants. However, at this point Ministries have different willingness to cooperate in the disbursement of grants, with some wanting an improved process and others wanting to maintain their independent ability to influence the grant making process. The Resolution is a step in the right direction, but is insufficient to achieve optimal project selection, design, and implementation.

Deficit Grants

Deficit grants are provided to assist local governments that have deficits "through no fault of their own" or local governments that go bankrupt. The total value of these grants is budgeted to be HUF 7 billion in 1998, up slightly from the 1997 level. During the year, the aggregate value of deficit grants can be increased using unspent funds from the addressed and targeted grant programs. At the peak, about 800 governments received these grants and about 600 obtained them in 1997.

A series of criteria has been established by Parliament to determine which local governments qualify for the grants. These criteria include: (a) municipalities must levy local taxes (in practice this seems to be interpreted as meaning the business tax), (b) capital expenditures must be less than capital revenues (presumably to ensure that current revenues are not being used to finance investments), (c) there must be no financial deposits with a duration of three months or more, and (d) the grants are only made to assist governments in covering mandatory tasks.

Applications for deficit grants are to be made to the TAKISZ offices by April 30th and September 30th of the year in which the grant is to be made. The TAKISZ offices analyze the applications to determine whether the local

[19] Resolution 263 also permits the Treasury to ensure that debts owed to the Central Government are met prior to any disbursement of funds.

governments qualify. The findings are reported to the Ministries of Finance and Interior which make a joint decision on whether a grant should be made and for how much. The joint decision is then presented to Parliament for review.

Deficit grants create perverse incentives because local governments can increase their grant revenues through behavioral changes. As a result, local governments that appear to be in relatively good financial condition can receive deficit grants. Local governments have an incentive to raise less of their own revenues and to increase expenditures on mandatory services. Certain revenues can be shifted from covering mandatory to non-mandatory expenditures and deposits can be held for periods just short of three months. Thus, the grant received by a municipality can depend heavily on its grantsmanship skills. Nonetheless, the aggregate magnitude of deficit grants is small, limiting the incentive effects.

II. ACCOMPLISHING NATIONAL GOALS WITH THE GRANT SYSTEM

No explicit statement is available on the transfer system*s goals, so the system must be interpreted based on its apparent objectives and based on practices in other countries. Transfers are normally made for one of three reasons. First, transfers are provided to enhance the overall government system*s vertical balance. Vertical balance exists when each level of government has access to sufficient revenues to meet its expenditure responsibilities. The notion is that the national government has access to more productive taxes (VAT, corporate income, and personal income taxes) than local governments, and these revenues should be shared with local governments where much of the expenditure responsibilities lie. Second, transfers are used to achieve a desired degree of horizontal balance because local capacity to raise own source revenues differs widely across areas. Third, transfers are used to encourage local governments to carry out national priorities.

At least to some extent, the transfer system achieves the three goals that the national government likely has for the system. Vertical balance is improved by shifting a large share of total government revenues from the national to the local governments. Several characteristics of the grant system improve the horizontal balance of the overall finance system, but different perspectives will exist about whether there is too much or too little being done to enhance the distribution of resources. The system also helps to accomplish some specifically defined national objectives. Nonetheless, the overall government revenue and grant system can be restructured to achieve these same objectives more effectively. The last two sections of the paper examine structural problems and alternative ways to raise revenues.

Vertical Balance

Given the broad responsibility of Hungarian local governments and their limited own source revenue capacity, creating a vertically balanced government structure is a key role for the transfer system. Local government expenditure responsibilities are well in excess of available local own source revenues, and the national revenue capacity is well above the expenditure responsibilities. The grant system helps provide the needed vertical balance to the overall government structure. Of course, an alternative approach would be to lower national taxes and transfers to local governments and to allow local governments much more authority to raise revenues from own sources. This option is considered further below.

Horizontal Balance

Wide differences exist in the per capita local government revenues generated from sources such as the derivation based PIT sharing and the business taxes. [20] Most analysts believe that some means of providing more even distribution of revenues is appropriate. Ensuring local governments a minimum level of per capita PIT revenues and providing normative grants are the most significant mechanisms used in Hungary for reducing horizontal imbalances. Through these programs, the structure can be thought of as contributing greater revenues to places with low capacity (less PIT revenues) and to places with greater expenditure needs (larger populations and more beneficiaries). Grants made to distressed municipalities and deficit grants are also intended to reduce horizontal imbalances. Finally, some grants made through the County Development Councils are targeted towards the least developed areas. Despite these various programs, differences in actual expenditures remain in Hungary. For example, 1995 per capita expenditures varied from HUF 52,900 in local governments with 2,000 to 4,999 people to HUF 79,400 in places with 20,000 to 49,999 people to HUF 123,800 in Budapest.[21] The spending differences can be caused by variations in service demands, expenditures needs, or revenue capacity.

Most grant systems around the world seek to reduce horizontal imbalances. However there is seldom a goal of achieving complete spending equality, because a tradeoff exists between giving local governments incentives for efficient behavior and equalizing local revenue capacity or spending levels. For example, local government incentives for raising revenues often are reduced by revenue equalization, though this distortion can be avoided if the capacity to raise revenues is equalized rather than the revenues.

National Priorities

The transfer system can assist in accomplishing two types of national priorities: targeting expenditures to high priorities and achieving overall macroeconomic objectives. Geographic externalities, which means that people living outside the direct delivery area benefit from the services being provided,

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[20] Per capita business tax revenues vary more than PIT revenues. See "Major Directions of Development of Local Governmental and Regional Regulations, with respect to the Requirements of the Accession to the European Union," Government of Hungary, Department for Local Governments, Regional Development and Housing Policy, February 1998.

[21] "The 1996 Budget and Hungarian Local Government Finance: Back to Office Report," William Fox, Rita Melhem, and Gabor Petri, September 26, 1995.

are a frequent reason why the national government places high priority on some services, such as health care, transportation, and education. There is a tendency to under provide these services because local governments ignore benefits for non-residents. In these cases, the central government can use the transfer system to encourage local governments to provide efficient service levels. There can also be a national policy to offer minimum levels of services such as health care. The national government should finance these service mandates.

The grant system is designed to ensure that national priorities are achieved, but much of the revenue is simply intended to provide financing for local governments. The normative grant system appears to have an underlying theme of encouraging local governments to provide services that are national priorities. However, local governments retain considerable flexibility to spend the normative grant resources on other programs, and at least in the case of social welfare the grants have not been spent as the Ministry of Social Welfare had hoped. Thus, the normative system has not been structured to require spending on national priorities.

Earmarking of grants is a means used to ensure that local governments spend at least that amount on the national priorities. The Government of Hungary earmarks transfers for theaters, fire protection, investment expenditures, and health care among others (see Table 4). Theaters and fire protection are unusual services to be financed with earmarked grants, because the benefits are likely to be very localized, with limited geographic spillovers. Local rather than national priorities normally should set service levels in these cases. On the other hand, investment expenditures are often targeted for areas such as clean water and sewer, which may have significant spillovers and which have been high national priorities. It is generally believed that the grants have encouraged local governments to select these projects. Earmarking is only effective in meeting national priorities if local spending decisions are influenced at the margin. Small earmarked grants, like for fire protection, may have no impact on local spending. Larger earmarked grants, such as for health care, probably do. Matching, open-ended grants can be a good means to affect local spending on smaller programs. These grants are infrequently used in Hungary.

Table 4
Categorization of Grants

	Local Control Over Funds	
Financing Source	**Earmarked**	**Flexible**
Ad Hoc	Theater Fire Brigade Ethnic Education Normatives Centralized Appropriations Most Extra-budgetary Funds Accumulation revenues inside the state budget Funds from budgetary institutions	Deficit Grants Most Normatives
Shared Tax	Road Fund	Derivation Based PIT Land Tax Motor Vehicle Tax Selected Normatives

The national government can also use the transfer system to accomplish macroeconomic goals. A frequent concern across the world is that the aggregate of local government fiscal behavior could dampen effects of national fiscal policies, or exacerbate cyclical trends. The dominant role that transfers play in local finance lessens the macroeconomic concerns, because the Government of Hungary can adjust local government revenues to support overall macroeconomic policies. The ad hoc nature of most grants maximizes the national government*s control over aggregate local finance.

III. STRUCTURAL CHARACTERISTICS OF THE GRANT STRUCTURE

The Hungarian transfer system can be summarized as:

— Very large on international standards
— Ad hoc in both aggregate size and distribution
— Administratively complex
— Distorting the efficient behavior of local governments

Importance of Transfers in the Intergovernmental Finance Structure

Wide variation exists across Europe and the world in the percent of local revenues raised through transfers (see Table 5) and the share provided through transfers is relatively high in Hungary. Transfers tend to play a large role in transition countries because of limited access to local own source taxes, and

Hungary*s share is high even by the standard of the transition countries (lower than Bulgaria and Romania, but the same or higher than other transition countries). Data in Table 5 are for 1996, when a lower percentage of revenues in Hungary came from transfers than the 72 percent that is budgeted for 1998 (see Table 6).[22]

Table 5—Percent of Local Government Revenues from Transfers

County	Percent
Albania	94
Austria	35
Belgium	78
Bulgaria	78
Czech Republic	45
Denmark	24
Finland	31
France	26
Germany	45
Greece	58
Hungary	**66**
Italy	38
Netherlands	60
Norway	33
Poland	60
Romania	38
Slovakia	39
Slovenia	67
Sweden	19
Switzerland	18
United Kingdom	77

Source: Council of Europe

Table 6
Intergovernmental Transfers as a Percent of Revenues, 1993-1998 (Percent)

	Budget of Local Governments (HUF Million)	1993	1994	1995	1996	1997	1998
					Preliminary		
	Revenues	Actual	Actual	Actual	Actual	Expected	Budgeted
1	PIT	8.46	8.69	11.85	10.77	13.28	16.37
2	Vehicle tax	0.43	0.35	0.31	0.75	0.78	0.74
3	Tax on Land Rent						0.09
4	Shared revenues total	8.89	9.03	12.16	11.52	14.07	17.20
5	Accumulation revenues within the state budget	1.13	2.18	0.94	1.26	0.98	0.79
6	Accumulation revenues total	1.13	2.18	0.94	1.26	0.98	0.79

[22] The availability of privatization revenues is one explanation for lower transfers in 1996 and 1997.

	Budget of Local Governments (HUF Million)	1993	1994	1995	1996	1997	1998
					Preliminary		
	Revenues	Actual	Actual	Actual	Actual	Expected	Budgeted
7	Normative subsidies from central budget	37.14	31.41	29.45	24.64	25.06	24.17
8	Subsidies to theaters	0.40	0.34	0.33	0.37	0.42	0.42
9	Addressed and targeted subsidies	3.17	3.48	3.06	2.49	4.50	3.76
10	PIT supplement	1.12	0.92				
11	Deficit Grant (ONHIKI)	0.27	0.62	0.89	0.57	0.59	0.63
12	Other subsidies (Centralized Appropriations)	2.26	4.19	4.13	5.62	3.58	3.31
13	Subsidies to local fire protection			0.32	0.77	0.86	1.02
14	Supplementary Grants to Certain Public Education Tasks					0.32	0.57
15	Investment Grants with Regional Equalization Perspective				0.06	1.08	0.79
16	Decentralized Targeted Oriented Grant (Investment)						0.38
17	Public Employees Wage, Minimum Wage	0.92	1.30	0.80			
18	Other regrouped revenues	0.03	0.18	0.49	0.23		
19	State transfers and grants total	45.32	42.44	39.46	34.76	36.41	35.04
20	Funds from Social Security	15.84	16.64	16.08	15.78	16.55	16.71
21	Funds from EBFs	0.41	0.49	0.43	1.35	1.47	1.66
22	Funds from budgetary (chapters) institutions	0.82	0.94	0.76	0.77	0.78	0.70
23	Budgetary supplements and refunds	0.86	0.71	0.15	0.14	0.15	0.09
24	Transfers within general government total	17.94	18.78	17.43	18.04	18.95	19.16
25	Total Transfers	73.28	72.43	69.98	65.57	70.40	72.18
26	GFS Revenues Total	100.00	100.00	100.00	100.00	100.00	100.00
27	GFS Expenditures Total			98.92	94.90	99.02	100.02
28	State transfers, PIT, Revenues from land rent	53.78	51.13	51.31	45.52	49.69	51.49

Source: Compiled from Ministry of Finance documents.

One justification given for such a large component of Hungarian local government finance coming from transfers is that local governments are

responsible for health care and education, and many national government officials appear to believe that the wages should be financed nationally. Transfers would still be more than 50 percent of local revenues, even with these categories excluded.

Annual Political Determination of Grants

The conclusion of this section is that the *total* amount of grant revenue shared with local governments is determined annually through a political process, and is not ultimately the result of a formula or a tax sharing arrangement. Two means are used in Hungary to determine the amount of revenue transferred to local governments through *each* grant program: a percentage of certain taxes and ad hoc political decisions. A listing of grant types according to these two methods is given in Table 4. The amounts used to finance normatives and earmarked, deficit, and investment grants are determined annually through an ad hoc political process, though the distribution of revenues across local governments is based on formulas in some cases. Revenues determined on an ad hoc basis account for more than two-thirds of transfers to local governments.

Available revenues from shared taxes are based on the specific tax*s collections. The percentage of shared PIT has varied nearly every year, from 100 percent in 1990 to 30 percent in 1994. The 40 percent currently being shared is set as part of a plan that was established in 1995. The PIT percentages may be more stable in the future, now that the plan has been implemented. The percentage allocated on a derivation basis has declined from 35 percent in 1995 to 20 percent in 1998. As previously noted, the remaining 20 percent in 1998 is linked to particular normative-like expenditures, including for PIT equalization (HUF 33.4 billion) and for social welfare (HUF 47.7 billion), depressed region (HUF 3.0 billion), and county (HUF 9.5 billion) normatives. Both shared taxes and normatives are listed in the budget according to the funding source, not according to how the revenues are distributed.

The contribution of different grant categories to overall local finance has changed dramatically since 1993 (see Table 6). Shared taxes, and particularly the PIT, have risen markedly as a percent of total transfers. The Social Security and other extra-budgetary funds have also increased their relative contribution. The normative grants, on the other hand, have fallen dramatically. Most of this change results from the way that revenues are categorized in the budget rather than a change in the financing structure. If the normative-like grants were recategorized from PIT sharing to normatives, the percentages would not have changed significantly.

Each national government makes political judgements on its aggregate

support for the local government sector, with the key differences being whether ad hoc decisions are made each year or whether the national government sets a broad policy that is expected to last for a period of years. The Hungarian central government and Parliament appear to evaluate most transfers to local governments as a package, and to raise or lower the components on an annual basis to achieve intended overall financing objectives. Indeed, the implicit plan appears to be to determine annually the total amount of resources in the local sector, including both transfers and own source revenues. Local government officials agree that the total value of transfers is negotiated annually, and one category of grants is reduced as another is raised so that the agreed upon total is reached. The annual negotiations seem to center around the shared taxes and most other transfers. The extra-budgetary funds and the Ministry programs that can be delivered either through local governments or non-government entities are not included in this negotiation. The perception that transfers are set as an aggregate is reinforced through their explicit summing in the budget (shown as line 29 in Table 1).[23] The constancy of transfers as a share of revenues also adds to this view. The percentage of local revenues provided by transfers has wavered somewhat over the years, but is expected to be nearly the same in 1998 as in 1993 through 1995.[24] Finally, the dominance of ad hoc revenues in the financing package makes it easy to offset patterns in shared revenues. For example, normative grants can be lowered to offset higher shared tax revenues. The frequent changes in the number and value of normatives are certainly suggestive that this is the practice.

To the extent that the overall grant structure is seen as a package, the sharing of taxes such as the PIT does not have any practical influence on the total amount of revenues that local governments ultimately receive, and is done for political objectives.[25] Thus, the two year lag for receipt of PIT revenues does not reduce the overall amount of local government revenues, which can explain why local governments do not appear to place a high priority on reducing the lag.

Administrative Complexity

The intergovernmental finance system entails high administrative costs for both the central and the local governments. The high costs of complying with the normative and investment grants were described in detail above. The process

[23] The sum of transfers in the budget does not include shared motor vehicle taxes.

[24] Privatization revenues may have distorted revenue patterns during 1996 and 1997.

[25] The PIT shared on a derivation-basis affects the distribution between local governments, even if not the total amount.

of calculating and disbursing the normatives requires significant effort, even though the revenues are not earmarked for the expenditure categories to which they are linked. The complicated normative structure appears to have been designed to achieve horizontal balance goals. Similarly, the investment grant process is very expensive because large resources are devoted to preparing and assessing grants applications. Of course, administrative costs for the grant system are small relative to the costs that would result from collecting the same revenue with local government taxes. But the goals for the grant system could be more effectively accomplished with a simpler grant system.

Effects on Efficient Local Government Behavior

The transfer structure has significant effects on local government accountability, incentives to raise local revenues, and motivations to select the best investment projects. The local revenue system could be redesigned to encourage local governments in each of these areas.

Accountability

A key expectation is that governments are accountable to their citizens. Local government accountability in Hungary is significantly hampered by the large role played by transfers. It is generally held that governments are more accountable for revenues that they raise through their own sources, at least in part because people often are unaware of the revenues that are transferred from one government to another. So they do not know which government to hold accountable for efficient use of the revenues. Also, the spending government is not required to enact and defend the taxes when service delivery is financed with transfers. For these reasons, local governments actually like to finance services with transfers.

Predictability and Planning

Governments must be able to predict their revenue flows if they are to engage in effective short, medium and long term planning. Some degree of unpredictability is inherent in all revenue structures because of the complicated relationship between revenue structures and economic growth. However, developing a predictable revenue system and undertaking effective planning are particularly difficult when transfers are based on annual political calculations. The problem is exacerbated because the distribution between local governments is uncertain until well into the fiscal year.

Raising Own Source Revenues

The transfer system must be structured to encourage (or at least not discourage) the generation of local own source revenues so that local governments can be held more accountable, can plan more effectively, and can meet local service demands. Also, citizen satisfaction can be enhanced because people are better able to relate receipt of services to payment of local taxes than to payment of national taxes.

Hungarian local governments have disincentives to raise own source revenues. One reason is that the small size of own source revenues means that big relative increases in local taxes have only a modest effect on total revenues. Local officials see little value in confronting the political consequences of higher taxes when effects on local service delivery will be limited. Another is that local governments have a disincentive to raise revenues if they believe that transfers will fall as a result. This tradeoff can occur in two ways. First, if all local governments raise more revenues, the central government can respond by lowering the amount of transfers and leaving the overall local sector with no additional resources. Local governments generally are apprehensive that the central government will respond this way, and are using it as an excuse not to raise own source funds. Second, in some cases there is a direct tradeoff between the revenues generated by specific local governments and their transfers. For example, deficit grants are a disincentive for local governments to impose their own taxes. The aggregate size of deficit grants is small, but many (and perhaps most) local governments receiving these grants are not using their maximum capacity to levy local taxes.

National taxes can be lowered as local governments generate more of their own resources. The need for lower national taxes in combination with greater local revenue generation may be particularly significant in places like Hungary where the aggregate tax burden is high.

Incentives to Adopt Good Projects

A good project finance structure is a key component of a system that results in selection of optimal investment projects. Anecdotal evidence is that Hungarian local governments select projects based on whether grant funding is available and that local government officials view receipt of grants as an important measure of their success. In some cases grants are intended to encourage local governments to select specific types of projects that are in the national interest, such as when grants are used to entice local governments to invest in projects with large benefit spillovers. However, in other cases local governments may simply elect to undertake projects because most of the funding is external, and the specific use of the funds may not be compelling.

Poorly structured transfer programs can cause local governments to select projects that are too large, not the most important priority for local needs, or based on inappropriate technology. Grants, and particularly matching grants, change the price of projects to municipalities so the same project selection decisions will not be made when financing is entirely local as when national funding is available. Also, decisions on project characteristics can be skewed by grant requirements. For example, provisions in the application process can lead to such practices as building water or sewer projects that are too large or selecting a technology that is not the best for the particular use. Further, local governments can be expected to opt for projects with high initial investment costs and low operating costs to ensure that national funding plays the maximum role in financing infrastructure services.

There are two obvious methods for improving the process. First, tighter selection criteria and more detailed review processes should be developed by the national government to ensure that selected projects are economically viable and are the highest priority. The number of applications must be reduced if the review is to be more than cursory, and tighter application criteria can be an important step in this direction. For example, limitations could be made more stringent on which local governments or projects will be considered for targeted grants. Second, local financial contributions, a frequent expectation of Hungarian grants, must be large enough to ensure that local governments are forced to consider the economic costs of each project. Conceptually, the local financial share of projects should equal the share of benefits received by local residents, and the national share should equal the proportion of benefits that occur as spillovers. In practice, the local government*s matching share is often very small, causing access to national financing to dominate local decisions on which projects to consider.

Local governments should make investment decisions based on lifetime project costs, including investment, operations and maintenance costs. In many cases, fees fail to cover operations and maintenance and investment costs, and the best option is to increase user fees. In the event that fees are not increased, local governments have an additional reason not to perceive the full implications of shortfalls. One alternative is for future recurrent costs to be seen as a national rather than a local responsibility, since local recurrent budgets are financed mostly through transfers. Under this scenario, new investments reflect a future commitment by the national government to provide sufficient life cycle financing, and represent little costs to local citizens. Another possibility is that transfer revenues will not rise with the recurrent costs. This means local governments incur greater risks as they take on the additional operating costs associated with new investments, because a means to finance the costs must be found. Local governments could reduce expenditures on other services, under maintain the

new infrastructure, or raise additional local revenues. A final possibility is for local governments to free up resources by shifting some expenditures to county governments.

In some cases the national government may design investment grant programs to offset inequalities in access to services. Matching components of a grant structure are normally a poor means of achieving this objective because lower income areas are less able to meet the matching criteria, and higher income areas often are better able and more willing to seek matching grants. Also, the matching ratio lowers the price of projects, which can result in inefficient investments from a national perspective.

IV. OPTIONS FOR ENHANCING THE TRANSFER SYSTEM

The Hungarian intergovernmental transfer system has evolved rapidly during the 1990*s and offers a number of positive features. But, the description of the system and the discussion of national goals and structural characteristics evidences that the system can be designed to operate more effectively. This section outlines some modifications that could be made, and addresses changes in the context of accession to the EU. Any changes cannot be seen in a vacuum because the local government budget constraint requires that local spending equal local own source revenues plus intergovernmental transfers. Relationships between the three elements of the fiscal equation mean that the best transfer scheme must be developed in the context of the entire local government sector. The starting point should be decisions on the responsibilities that local governments will undertake. Then a system for financing these services, using both intergovernmental and own source revenues, must be identified. Despite these linkages, this section only examines the intergovernmental finance component of the local government sector.

The transfer system can be modified to enhance all four aspects of local government behavior described in the previous section: accountability, predictability, local revenue generation and administrative costs. These improvements can be achieved through two basic changes in the local finance system: imposition of local income tax surcharges and use of a simplified formula grant structure. Analysts of the Hungarian local government sector have previously suggested both ideas.

Local Income Tax Surcharge

Reducing the shared PIT, combined with allowing local governments the authority to impose PIT surtaxes, would be an effective way to improve accountability.[26] National PIT rates should be lowered correspondingly to maintain the share of personal income paid in taxes. Local governments would be permitted to use surtaxes as necessary (though a maximum rate could be imposed) to replace lost shared tax revenues and to expand local revenues if additional responsibilities are devolved to local governments. This set of policies would cause local governments to be more accountable by requiring them to enact legislation that would generate more of their own revenues and by allowing residents to be more aware that revenues are being spent by their local governments. Also, local governments would have a greater capacity to set differential tax rates and generate local revenues according to variations in local service demands. Of course, the resulting horizontal imbalances (which would not be very different from the current derivation-based tax sharing) are a disadvantage since the per person income tax base will differ widely between areas. The grant formula described below can be used to reduce horizontal imbalances.

A minimum surtax rate could be imposed to limit tax competition between local governments. The minimum can be set by either continuing to have some tax sharing or by enacting legislation that sets a minimum local rate, since the effects are similar. Administration of the surtaxes would not be very different from the existing shared taxes—the Tax Department would still be required to report revenues based on where people live. A significant difference is the Tax Department would need to collect the tax revenues at surtax rates that differ between local governments. Also, local governments would place much more pressure on the Tax Department to reduce the two year lag that currently exists in distribution of PIT revenues.

Suppose that all derivation based PIT sharing was eliminated, national PIT rates were reduced accordingly, and local governments were permitted to impose a surcharge to offset the revenue loss. If the same amount of total revenue is to be raised, national tax rates must be reduced by 20 percent, and local governments must impose an average surcharge of 25 percent.[27] In 1998,

[26] Income surtaxes are used in a number of countries including Denmark, Sweden, Belgium, Canada, and the United States.

[27] In fact, the reduction in the national rate could be smaller because of the existing two year lag between when revenues are collected and when they are received by the local governments. The national rate would only need to be reduced by 15 percent, and the surcharge would be an average of 18 percent if the revenues could

this change would raise the percentage of local revenues raised from own sources from 28 percent to 36 percent. The reduction in national PIT would need to be 42 percent, and the surcharge on the remaining national tax rate an average of about 72 percent, if the goal was to increase own source revenues to 45 percent of total local revenues.[28]

Grant Formula

A simplified grant formula could make revenues more predictable and could reduce administrative costs. Revenues would be more predictable if the grant formula was developed and left in place for several years. The system would also be more predictable if the factors used to determine the amount granted to each local government, such as population, did not change radically from year to year. A significant reduction in the number of factors used in the grant formula would also lower administrative costs. Of course, a more limited set of other normative grants, investment grants, and other grants could be retained.

Every formula has two components, one determining the total amount of grants for local governments and the other deciding how these grants will be distributed between the sub-national governments. The total amount to be transferred would ideally be set based on a percentage of total national government tax revenues, or a percentage of a particular tax. For example, about 60 percent of PIT revenues would need to be distributed to local governments if the amount of normative grants (see Table 2) was financed with a share of the tax. Grants based on a broad set of national taxes are normally preferred because local governments share in the overall capacity of the national government to raise revenues.

The distribution of revenues between local governments is intended to help provide budget balance and to give the greatest assistance to places with the least capacity to provide for their own needs. Intergovernmental transfers based on a formula that provides larger grants as a local government's expenditure needs rise and as its revenue capacity decrease are the best means for alleviating horizontal imbalances. The formula would have the structure, G = r (E-R), where G is the grant amount, E is a limited number of expenditure needs, R is revenue capacity, and r is the amount the grant rises with needs and falls with

be distributed concurrently with when the taxes are collected.

[28] The national rate would need to be reduced by 31 percent and the average surcharge set at 45 percent if the revenues could be distributed concurrently with when the taxes are collected.

capacity.[29] The normative system operates like part of the equation, where the E is the different normatives and the r is the values assigned to each normative. The main differences between the existing system and one based on the simplified grant structure are the large number of normatives and the very limited role that revenue capacity plays in the existing system.

The grant formula must be based on objective measures of expenditure needs, such as the number of children of school age, to prevent local governments from altering
their behavior to collect more revenues. Local governments can change their grant amount if expenditure needs are based on factors that are under their control, such as number of hospital beds or number of school classrooms. This results in inefficiencies as local governments design service delivery to maximize revenues. A major difference from the existing normative system is that a much smaller number of need indicators would be included in the formula (one of which would probably still be population). National priorities can be reflected through the specific expenditure needs that are chosen for the formula. Similarly, objective measures of revenue capacity, such as the amount of revenues that would be collected at average tax rates or regional measures of income, must be adopted to prevent local governments from reducing their revenues to raise their grant amount. A formula based on *actual* collected revenues gives local governments the incentive to raise less of their own revenues.

Accession to the European Union

Implications of the transfer system for accession to the European Union (EU) are indirect rather than direct. The main effects come through the role that transfers play in creating a functioning Hungarian government structure. The transfer system needs to encourage efficient service delivery, selection of the best projects, and so forth.

A major expectation for EU entrants is that they have coordinated, effective regional development strategies. To meet this requirement, Hungary has taken the initial step of forming a regional development structure, composed both of multi-county regions and County Development Councils. The structure is still in its infancy, so the responsibilities and working methods of these organizations are not fully delineated. Operation of the two infrastructure grant programs that were described above is a responsibility of the County Development Councils, but the multi-county development organizations are not yet operational.

[29] A different grant rate could be attached to expenditure needs and to revenue capacity.

Countries must also have a mechanism for receiving and using EU structural grants. The multi-county and county development organizations can ultimately serve these purposes as they become operational, effective units. However, the EU requires matching funds and neither organization has any own source revenue capacity. Both are dependent on transfers from the national or local governments for financing their grants and their operational expenditures. As noted above, governments normally make more effective decisions when some of the money comes from local contributions. So, for these development organizations to be most effective a formalized system should be put in place for local money to serve as counterpart funds for EU investments.

Good use of EU structural funds requires a mechanism for identifying optimal investment projects. Parliament*s allocation of funds across sectors (through the targeted grants, earmarked funds, and centralized appropriations) can serve as the mechanism for reflecting national priorities and for meeting EU objectives. However, the existing complex, disjointed system for selecting the specific projects to be funded is unlikely to lead to optimal choices. Grantsmanship and political criteria appear to play a very large role in the selection process. The steps which the Government has identified to fulfill Resolution 263 are a movement in the right direction. Greater reliance on local revenue sources including user fees, stringent evaluation of projects in terms of economic viability (cost benefit analyses, etc.), and tighter application criteria (to reduce the number of applications) would all enhance the project selection process and increase the chance that EU structural funds would be targeted to the highest priority areas and would be used for the best projects.